

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Haynes Analyst: LuAnna Hass Bill Number: SB 366

Related Bills: See Prior Analysis Telephone: 845-7478 Amended Date: August 22, 2001

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Taxpayer Bill of Rights/No Levy May be Made on Principal Residence of Innocent Investor/Release of Certain State Tax Liens

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

X AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as amended July 10, 2001.

X FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED July 10, 2001, STILL APPLIES.

OTHER - See comments below.

SUMMARY

Under this bill, when a taxpayer proves that they unknowingly participated in a fraudulent tax scheme that resulted in a state tax liability, the Franchise Tax Board (FTB) would be:

- * prohibited from seizing and selling (levying) the principal residence if the reason for the levy is the underpayment of tax as a result of an investment in an abusive tax shelter.
- * required to release the proceeds from the sale or other transaction related to the levying of a principal residence.
- * required to release any state tax lien, including liens that survive the bankruptcy of an innocent investor, if the reason for the lien is the underpayment of tax resulting from an investment in an abusive tax shelter.
- * required to return any proceeds from the sale of a principal residence that were received in satisfaction of a state tax lien or as a result of a levy, upon written notification from the innocent investor.

In addition, this bill would allow taxpayers to take an action against FTB as a result of a denial of a return of the proceeds.

Board Position:

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Legislative Director

Date

Brian Putler

08/30/01

SUMMARY OF AMENDMENTS

The August 22, 2001, amendments would make various technical changes to the bill, including, but not limited to:

- * changing the name of the notice sent to taxpayers that have been denied a return of proceeds to a "notice of denial"; and
- * changing the term for not fulfilling a request for a return of proceeds from "disallowed" to "denied."

The August 20, 2001, amendments resolved the department's implementation concern and a policy concern as discussed in the department's analysis of the bill as amended July 10, 2001. Specifically, the amendments would:

- * revise the eligibility criteria for determining whether a taxpayer is an innocent investor by eliminating the requirement that the individual "did not know" the entity, plan, or arrangement would be an abusive tax shelter, and adding a new requirement that the individual reasonably believe that the individual's tax treatment of an item attributable to an abusive tax shelter was, more likely than not, the proper treatment of that item;
- * require FTB to return any proceeds from the sale of a principal residence that were received in satisfaction of a state tax lien or as a result of a levy upon written notification from the innocent investor;
- * require any amounts returned to the innocent investor to include interest;
- * clarify that any amount returned must first be credited against any other liability due;
- * require the notification and substantiation of the innocent investor status to occur within one year of the date the proceeds are received by FTB;
- * allow the owner to consider a request for the return of proceeds to be disallowed if FTB fails to mail a notice of action within six months from the date of the request;
- * allow the owner of the principal residence to bring an action against FTB within one year from the date the proceeds are received by FTB or 90 days after FTB disallows the request for the return of the proceeds, whichever period expires later; and
- * make a technical correction regarding the reference to the Code of Civil Procedure.

Except for a new revenue estimate and technical concern, the remainder of the department's analysis of the bill as amended July 10, 2001, still applies. The new revenue estimate and all remaining concerns are included below for convenience.

POSITION

Pending.

TECHNICAL CONSIDERATION

As a result of the August 22, 2001, amendments, this bill would allow the owner of a principal residence to take an action against FTB when a request has been denied for the return of the proceeds "from the sale of the principal residence by FTB." The language could be construed to permit the owner to take an action against FTB when the department seizes and sells a home and the owner's request for a return of the proceeds is denied. This language could be interpreted to prevent the owner from taking the same action against FTB when the owner is denied a return of proceeds FTB received in satisfaction of a lien. According to legislative staff, the intent was to allow an action against FTB for the return of the proceeds that were **received** by FTB from the sale of the principal residence. Legislative staff has indicated that the bill would be amended to reflect the intent.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in revenue losses as shown in the following table:

Estimated Revenue Impact of SB 366 As Amended 8/22/01 [\$ In Millions]			
	2001-02	2002-03	2003-04
Innocent investors and refund of levy/lien amounts	minor loss	minor loss	-\$1.0

Minor loss is less than \$500,000.

The August 20, 2001, amendments provide that only funds received after January 1, 2002, are eligible for return to the owner under this bill. The amendments further specify that in order for the return of funds to occur, the taxpayer notification and substantiation of the status as an innocent investor must occur within a one-year period beginning with the date the proceeds are received by FTB. This time limitation reduces the previous estimate for the 2002-2003 and 2003-2004 fiscal years from potentially significant to a minor loss in 2002-2003, and a loss of \$1 million in 2003-2004.

Revenue Discussion

The revenue impact of this bill would be determined by the amount of foregone collections that would otherwise have resulted from state tax liens recorded on an innocent investor's principal residence or escrow or other accounts holding proceeds from the sale of such residence.

Circumstances placing a taxpayer in the position of an "innocent investor," as defined, would appear to be rather limited. However, the bill would eliminate a collection tool in these circumstances. When no other means of collection exists, a lien attaching to a principal residence secures the unresolved tax debt. In addition, a tax lien recorded before a bankruptcy petition is filed would survive a bankruptcy proceeding. Under these circumstances, a lien becomes the only means of securing a tax debt.

The department is currently holding (pending final federal determination) approximately 400 assessments issued to about 100 investors in partnerships who were California residents. Assessed taxes average approximately \$3,000 per tax year and four tax years per investor (total of \$12,000). Tax years at issue range from 1975 through 1994 with accrued interest increasing amounts due substantially. Each of these partners could fall into the innocent investor category of this bill.

If, in any given year, the total number of innocent investor liens for all relevant cases for which bankruptcy proceedings have been completed were 25, the amount of tax and interest potentially at risk would be around one-half million dollars (assuming an average balance due of \$25,000).

This bill would extend the innocent investor relief to individuals who are shareholders in other entities such as S corporations that invest in abusive tax shelters. An innocent investor also could include beneficiaries or trustees that have participated in fraudulent tax evasion schemes that are packaged as legitimate trusts, although it is unlikely many of these investors would meet the "reasonably believed" criteria in the amendment. The Internal Revenue Service (IRS) estimates the federal government is losing billions of dollars of tax revenue from these fraudulent tax evasion schemes that are packaged as legitimate trusts. The IRS further indicates that a large percentage of these elaborate tax schemes to conceal income and create false business expenses for investors are becoming more common in Northern California. To the extent these investors would fall into the innocent investor category of this bill, foregone collections of tax revenue would increase significantly.

ARGUMENTS/POLICY CONCERNS

Current laws and FTB practices, on a case-by-case basis, would provide tax relief to "Hoyt"-like taxpayers experiencing financial hardship and free their personal residence from levy and liens. Some may argue that current law and practice are sufficient to protect any of these "Hoyt" taxpayers who are truly "innocent partners."

Many taxpayers that are not investors in abusive tax shelter partnerships experience devastating financial hardships. The intent of this bill is to offer tax collection protections to these certain partners beyond those given to other similarly situated taxpayers.

This bill would allow proceeds from a sale of the principal residence, regardless of the amount of the proceeds, to escape a recorded state tax lien. This policy would be in conflict with the law that allows liens to be released only if the release will not endanger or jeopardize the collection of taxes.

There have been several recent efforts at the federal level to discourage corporations from investing in abusive tax shelters. These efforts have included regulatory action by the Treasury Department and the introduction of proposed federal legislation. While such legislation has not been enacted, this bill would move in the opposite direction by creating the possibility that taxpayers who invest in some of the most aggressive shelters may ultimately avoid paying the correct amount of tax.

Federal bankruptcy law allows tax liens to survive a taxpayer's bankruptcy proceeding. This bill would be inconsistent with bankruptcy law because FTB would be required to release tax liens on an innocent investor's principal residence. A lien release under these circumstances would result in the loss of a collection tool for the department and benefit other taxing agencies in other states and the IRS. That is because the federal government and other states do not have similar laws and are not required to release liens under the same circumstances.

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